No. 16201

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

BANKLINE OIL COMPANY,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BRIEF ON BEHALF OF PETITIONER BANKLINE OIL COMPANY.

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Opinion Below.

The opinion of the Tax Court of the United States is reported in 30 Tax Court, Number 44. [Tr. p. 20.]

Jurisdiction.

This case comes before the Court under the provisions of Section 7482 of the Internal Revenue Code on the Petition for Review of a Decision and Order of the Tax Court of the United States (which took jurisdiction under the provisions of Sections 7442 and 6213(a) of the Internal Revenue Code) determining a deficiency of $14,-342.52 in the 1952 Federal corporate income tax of petitioner.

The Commissioner of Internal Revenue had proposed a deficiency of $14,342.52 for 1952 by denying petitioner a capital gain treatment on $85,000 it received from the sale of eight casinghead gas contracts to Signal Oil and Gas Company. [Tr. 11-16.]

The Tax Court found that petitioner received such amount for giving Signal Oil and Gas Company a processing job for casinghead gas and that such amount was ordinary income when received by petitioner. [Tr. 43-44.]

Petitioner also claimed before the Tax Court that the further amount of $11,351.41 which it received in 1952 from Signal in the same transaction should also be treated as long-term capital gain. [Tr. 4-10.] The Tax Court also found that amount was ordinary income and not long-term capital gain. [Tr. 44.] On this appeal, petitioner adheres to this point, but in the alternative it takes the position that it sold approximately a 30% interest in the contracts for $85,000 and reserved the balance, with Signal agreeing, as part of the consideration for the 30% interest, to process petitioner's reserved share.

Question Involved.

Are the amounts petitioner received from Signal entitled to capital gain treatment as proceeds from the sale of casinghead gas contracts, or are they ordinary income received for giving Signal a gas processing job for more than normal compensation?

Statement of the Case.

The petitioner is a California corporation, organized in 1912 and has its principal office in Los Angeles, California. It filed its income tax return for 1952 with the district director in that city. During the years involved herein the petitioner kept its books and filed its income tax returns on an accrual basis. [Tr. 55-56.]

The petitioner's business consists of the processing of casinghead gas, hereinafter sometimes referred to as wet gas, derived from the production of petroleum oils, into its separate ingredients, including natural gasoline, dry gas and propane gas, and the operation of a petroleum refinery where natural gasoline is blended with other gasoline and after being refined is purveyed to the public through retail outlets. Its refinery is located at Bakersfield, California. Its processing plants were during 1952 and prior thereto located in Santa Fe Springs, Maricopa and Signal Hill, California. An important determining factor with respect to profitable operation of a casinghead gas processing plant is the availability of an adequate supply of gas so that the plant may be operated at as nearly as possible its full capacity. [Tr. 56, 57, 231, 242.]

More than 6 months prior to November 1, 1952, petitioner had entered into eight separate contracts with oil producers, hereinafter referred to as producers, for the acquisition by it of casinghead gas produced from drilling operations in the Signal Hill Oil Field. [Tr. 57, par. 7.] The contracts generally each provide that petitioner was to install and maintain pipelines from producers' wells or gas traps to its Signal Hill processing plant; that it equip the lines with meters so that accurate account might be kept of all gas emanating from the wells of individual producers; that the producer would deliver the wet gas produced at his wells to the pipeline; that petitioner was to process the gas and pay each producer a percentage of the total gross proceeds derived from petitioner's sale or use of the natural gasoline and propane gas extracted by such processing. The producer had an option to receive payment in kind if he

so desired. Upon completion of the processing, petitioner had the right to sell to others all of the product not required to be returned to the producer and thereupon to pay the producer not being paid in kind, a stipulated percentage of the gross sale price received. Petitioner had the right to and did use the natural gasoline so derived in its refinery and was required to pay the producer an equivalent royalty therefor based upon the market price thereof. [Tr. 70-181, Exs. 2-A to H.]

The natural gasoline used by petitioner in its refinery under the contracts referred to was not the identical gasoline resulting from its processing operation. Such gasoline was obtained at its Bakersfield refinery from Standard Oil Company of California through an exchange agreement with that concern. By virtue of the exchange agreement petitioner escaped the cost of transporting its natural gasoline from its processing plant at Signal Hill to the refinery.

The Signal Oil and Gas Company, hereinafter referred to as Signal, owned and operated a processing plant for casinghead gas located in the Signal Hill Oil Field. [Tr. 234.] During the fall of 1952 petitioner determined that the operation of its processing plant in Signal Hill was unprofitable or in danger of becoming so because of an inadequate supply of gas and for that reason sought a profitable method of divesting itself of its processing plants and equipment and casinghead gasoline contracts. [Tr. 231, 232.] To that end, in the fall of 1952, it began negotiations with Signal for sale to the latter of its processing plant and casinghead gas contracts in Signal Hill. [Tr. 231, 233.] On November 1, 1952, the negotiations culminated in the sale by petitioner to Signal for $50,000 of its Signal Hill

processing plant, pipelines, pipes, meters, and fittings in the Signal Hill Oil Field (except the pipelines, pipes, meters, and fittings located on the properties from which wet gas was currently being delivered under the above-mentioned eight contracts with oil producers), together with other properties owned by petitioner consisting of oil leases, interest in lands and gasoline storage for pier facilities located in Santa Barbara County, California. [Tr. 233-236, Ex. 1, Tr. 63-69.]

On the same date, a separate agreement was entered into by petitioner and Signal. [Tr. 182-187, Ex. 3.] This agreement was effected by petitioner's acceptance on November 1, 1952, of the following offer of Signal contained in a letter addressed to petitioner and dated October 29, 1952:

> "Subject to the conditions and for the considerations hereafter set forth, Signal Oil and Gas Company hereby offers to purchase from you the following properties, to-wit:
>
> "All leases, gas contracts or other purchase agreements held by Bankline for the purchase or processing of wet gas from properties located in the Signal Hill Oil Field. A schedule of said instruments is hereunto attached and by this reference made a part hereof and marked Exhibit 'A'.
>
> "Signal Oil and Gas Company offers to pay for the above-described properties the sum of $85,000, plus further sums of money calculated in the following manner:
>
> "Signal shall process said wet gas, or cause said wet gas to be processed, at its plant in the Signal Hill Oil Field or at such other plant or plants as Signal shall hereafter elect, whether or not said plants shall be owned and/or operated by Signal. All dry

gas resulting from said operations not required to be returned to the properties from which produced shall be sold by Signal and the net sales price paid to Bankline monthly. All natural gasoline and LPG Propane extracted by Signal from said wet gas shall likewise be sold by Signal at the average price it receives for like products sold by Signal, and Signal shall pay Bankline monthly a sum of money equal to the sales price of said natural gasoline and LPG Propane, less the following sums, to wit:

> The sum of 2½¢ per gallon on all natural gasoline and the sum of 1¼¢ per gallon on all LPG Propane.

"Said deductions are based upon the present price of 8.33¢ per gallon posted by Standard Oil Company of California for 21# R.V.P. natural gasoline in the Signal Hill Oil Field and shall be increased or decreased at the times and in direct proportion to any increase or decrease above or below said price of 8.33¢ per gallon posted by Standard Oil Company of California for 21# R.V.P. natural gasoline in the Signal Hill Oil Field.

"Connections shall be established between the wet gas lines presently owned and operated by Bankline and those presently owned and operated by Signal at two locations, to wit: in the proximity of Temple and Hill Streets and in the proximity of Willow and Walnut Streets, Signal Hill, and transmission of said gas shall be made at said points or at other points if in Signal's judgment other connections shall be required. Signal shall also connect its dry gas lines to the dry lines presently owned and operated by Bankline in the proximity of Cherry and Willow Streets for delivery of gas to the properties from which it is produced, when such re-delivery shall

be required. Signal shall meter the wet gas in master meters installed for said purpose and shall make all applicable tests at said points, accounting to Bankline for the entire amount of wet gas received pursuant to this agreement without allocation as to the individual properties from which said gas is produced.

"Signal in its operations hereunder shall use the same metering, testing, and accounting procedure currently used by Signal in connection with other wet gas being purchased by Signal in said Signal Hill field and drips secured from the pipeline system of Bankline will be accounted for on the same basis as other drips collected by Signal; provided, however, that such procedures of metering, testing and accounting shall conform with the provisions of the agreements described in Exhibit 'A' as modified from time to time by usages and customs in the industry.

"This agreement shall remain in full force and effect for the period of ten years from November 1, 1952, and thereafter so long as Signal shall elect. In the event that at any time after ten years from November 1, 1952, Signal shall desire not to receive and/or process the wet gas produced from the properties described in Exhibit 'A' it shall give written notice to that effect to Bankline. Within thirty days after said notice Bankline by written notice to Signal may elect to purchase the leases, gas contracts and other purchase agreements herein purchased from Bankline for the sum of $10.00 and have such of said leases and other agreements then remaining in effect reassigned to it, and upon notice to that effect Signal shall reassign all of said leases and agreements. In the event Bankline shall not elect to receive such reassignments, then Signal may without

> further obligation to Bankline sell or assign said agreements to third parties or may quitclaim, surrender or otherwise terminate any or all of them."

Under this contract Signal was to get 30% of the casinghead gasoline and propane at all times (2.50 ÷ 8.33 is 30%). [Tr. 183.]

The contracts listed in Exhibit A mentioned in the foregoing agreement were the eight contracts with oil producers heretofore mentioned. [Exs. 2-A to 2-H, Tr. 70-81.] Pursuant to the foregoing agreement, petitioner on November 1, 1952, executed an "Assignment" which recited that petitioner did thereby assign to Signal "all its right, title and interest in, to and under" the eight contracts. [Ex. 10, Tr. 215.]

The payment of the $85,000 amount called for by the agreement was by Signal's noninterest-bearing note, dated December 1, 1952, in that amount, providing for installment payments of $4,000 monthly over a 20-month period and a final payment of $5,000. [Ex. 4, Tr. 187.] Subsequently, the note was paid in accordance with its provisions. [Tr. 264.]

On November 1, 1952, petitioner and Signal orally entered into another agreement which was reduced to writing on December 1, 1952, and was set out as follows in a letter from Signal to petitioner dated December 1, 1952:

> "Reference is made to our letter to you dated October 29, 1952, wherein Signal Oil and Gas Company offered to purchase from you certain leases, gas contracts and other purchase agreements held by Bankline for the purchase or processing of wet gas from properties located in the Signal Hill Oil

Field, which offer was accepted by you under date of the .... day of November, 1952.

"Signal Oil and Gas Company hereby agrees to sell and deliver to you natural gasoline in monthly amounts equivalent to the amount of natural gasoline extracted by Signal from the wet gas processed by it under the provisions of the above-mentioned letter agreement of October 29, 1952. The term of this agreement shall be ten years from November 1, 1952, and so long thereafter as Signal shall be receiving wet gas produced from the above-mentioned wells.

"The sales price of all natural gasoline delivered pursuant to this agreement shall be the average price received by Signal during the month in which deliveries are made for natural gasoline of like quanity sold by Signal in the Signal Hill Oil Field.

"Nothing herein contained shall be construed as requiring us to produce a product of any particular vapor pressure, but delivery shall be made in such product as Signal shall from time to time be producing at the plant in which the above-mentioned wet gas is processed." [Ex. 7, Tr. 203.]

During the negotiations Signal, for accounting and tax purposes, desired that the $135,000 purchase price for petitioner's properties be broken down and allocated in the contracts herein referred to—$85,000 for the casinghead gas contracts; $25,000 for the processing plant and equipment, and $25,000 for the other assets of petitioner. [Tr. 239, 240.] Petitioner was at first indifferent with respect to an allocation, but later became concerned lest the allocation for the processing contracts be determined to constitute ordinary income. It ex-

pressed its concern to Signal and, as a result, that company, by letter also dated December 1, 1952, agreed

> "to indemnify and hold Bankline Oil Company harmless from the payment of any greater United States corporate income tax pursuant to Sections 13, 15 and 430 of the Internal Revenue Code on the receipt of said sum of $85,000.00 than the said income tax calculated on said sales price pursuant to Section 117 of the Code." [Ex. 5, Tr. 188, 244.]

There was no discussion between the representatives of petitioner and Signal that petitioner employ Signal to process the wet gas from the eight casinghead gas contracts for petitioner for compensation. [Tr. 240, 247.]

On its acquisition of petitioner's Signal Hill processing plant, Signal dismantled it but connected its main pipeline to petitioner's former line and thus conducted the wet gas formerly processed by petitioner to its Signal Hill processing plant. A meter was installed by Signal upon its main pipeline and it thereafter accounted to petitioner for the total gas received by that means. [Tr. 58, par. 12; 234, 235.]

Subsequent to the above transaction, petitioner continued to own and maintain the pipelines to the producers and the meters used in connection therewith and made regular meter readings of the gas received from each producer. The petitioner continued to be liable to the producers for royalties on the gas obtained from them and continued to maintain its own royalty records and to compute and to pay royalties due the individual producers. [Tr. 58, par. 11; 234, 235.]

Generally, petitioner's operations with Signal were carried on as follows:

All the natural gasoline produced by Signal under the contracts with the oil producers was sold to petitioner [Tr. 203, Ex. 7] and delivered to Standard Oil Company of California under an exchange agreement for the account of petitioner. [Tr. 254, 255.] At petitioner's direction a portion of this gasoline was delivered by Standard Oil Company to one of the producers to satisfy petitioner's obligation to deliver natural gas as a royalty in kind under the contract between petitioner and that producer. A quantity equal to the balance of the natural gasoline produced was delivered by Standard Oil Company to petitioner at the Bakersfield refinery pursuant to an exchange agreement between Standard Oil Company and petitioner. [Tr. 254-257.]

Signal billed petitioner for the entire amount of natural gasoline extracted by Signal from the wet gas processed under the contracts with the oil producers, and petitioner paid this amount to Signal. [Tr. 60, 209, Ex. 8-B.] Signal then paid petitioner the amount required by Exhibit 3. [Tr. 210, Ex. 8-C.]

The liquid propane extracted by Signal from the wet gas processed under the contracts with the oil producers was sold to third parties by Signal. The total sales price was received by Signal, and the amount required by Exhibit 3 was paid by Signal to petitioner. [Tr. 60, item b.]

The dry gas was handled in the following manner:

A portion of the dry gas was returned to the leases as required by the contracts with the oil producers. [Tr. 60, item d.] Where the dry gas returned to the

leases was in excess of the amount required under the contracts, petitioner billed the producers directly and received the proceeds. [Tr. 60, item e.]

A portion of the dry gas was delivered to one of the producers by Signal for the account of petitioner to satisfy petitioner's obligation to deliver dry gas as a royalty in kind under the contract between petitioner and that producer. [Tr. 60.]

The remainder of the dry gas was sold to third parties by Signal and the entire proceeds were remitted to petitioner. [Tr. 60, 183, Ex. 3.]

Signal, although using less than its total capacity as of the fall of 1952, was operating its Signal Hill processing plant with an adequate supply of casinghead gas. [Tr. 239.] Its processing of additional gas which it might obtain through petitioner's contracts with producers would be at only a slight increase in its cost of operation. [Tr. 239.] Such gas was unusually rich in that it produced between 8 and 9 gallons of natural gasoline per 1,000 cubic feet of gas. [Tr. 239.] The royalties to producers under petitoner's eight contracts averaged about 42 per cent of the value of natural gasoline and propane gas produced by the processing of wet gas emanating from their wells. [Exs. 2-A to 2-H, Tr. 70-182.] In 1952 the going rate of such royalties to all producers in the Signal Hill area was about 55 per cent. [Tr. 236.] Signal believed the production of casinghead gas from wells in this field would remain relatively constant over a number of years. [Tr. 239.]

During 1952 the usual charge in the Signal Hill Oil Field for processing wet gas varied between $0.0075 and $0.0085 per gallon of natural gasoline resulting

therefrom. [Tr. 241.] Ordinarily in 1952 in the Signal Hill area a contract to process wet gas was characterized by an agreement to extract natural gasoline propane and dry gases therefrom for a fixed price per gallon of gasoline thus produced. All products of the extraction process were returned to the owner of the wet gas or other entity having the right to such products. No title to the wet gas passed to the processor. Such contracts were also characterized by provision for their termination on relatively short notice. To pay a processor a bonus for his services was not customary. [Tr. 241.]

On its books Signal treated the November 1, 1952, transacton relating to the eight producers' contracts as constituting the acquisition of a capital asset and has amortized the amount of $85,000 as the cost thereof over their probable life. Signal treated the further amounts paid to petitioner as deductible "royalties." [Tr. 62, 209.]

Petitioner treated the $85,000 as the sale price of the eight contracts. [Tr. 14, 15, 269.] On its books petitioner has treated Signal's subsequent disposition of the products produced as petitioner's sales of those products and the amounts retained by Signal as its charges for processing.

Petitioner kept its books in that manner to satisfy the provisions of the casinghead gas contracts that the sales of all products produced from the wet gas under the eight contracts were to be shown on petitioner's books for the purpose of inspection of the royalty figures by the eight gas producers. [Exs. 8-A to 8-H, Tr. 10-182.] If the petitioner had not undertaken to continue to pay

the producers the royalties it would not have kept its books in that manner. [Tr. 269.]

The oral agreement which was reduced to writing on December 1, 1952, relative to the sale by Signal to the petitioner of natural gasoline equivalent in amount to that obtained through the eight producers' contracts here involved, was cancelled by the parties thereto on October 9, 1957, effective as of October 1, 1957. [Tr. 250.] Thereafter Signal sold the casinghead gasoline to Standard Oil Company at the same price it had been receiving from petitioner. [Tr. 242, 204.]

Petitioner at approximately the same time cancelled other contracts by which it had been purchasing natural gasoline, as its inventory of natural gas exceeded its needs therefor. [Tr. 252.]

The petitioner was not engaged in the business of buying and selling casinghead gas contracts. [Tr. 57.] It had no cost or other basis for the eight producers' contracts involved herein. [Tr. 57.]

The following is a statement computed on an accrual basis showing the results of Signal's and petitioner's operations for the months of November and December, 1952, and the years 1953, 1954 and 1955, with respect to the eight producers' contracts involved herein:

	1952	1953	1954	1955
Total value of natural gasoline produced by Signal	$30,557.27	$243,189.78	$231,449.15	$228,378.35
Total amount of propane gas sold third parties by Signal	666.73	5,529.09	5,401.10	4,814.48
Total amount received by Signal from sale of dry gas not consumed by oil and gas producers nor by Signal	1,817.14	13,997.25	13,869.17	16,229.30
Total amount of dry gas delivered by Signal as royalty in kind for account of petitioner	942.66	7,201.64	7,129.82	8,226.81
Total amount of dry gas returned to leases in excess of amounts required by leases	57.57	275.55	229.26	227.47
Total	34,041.37	270,175.31	258,078.50	257,876.41
Portion of sales price of natural gasoline and propane gas retained by Signal	10,235.87	79,196.89	75,026.84	74,772.56
Amounts remitted by Signal to petitioner	23,805.50	190,978.42	183,051.66	183,103.85
Royalties paid by petitioner (plus fair market value of natural gasoline and dry gas delivered in kind)	12,454.09	96,488.68	92,048.81	92,638.42
Net amount remaining after petitioner's payment of royalties to producers	11,351.41	94,489.74	91,002.85	90,465.43

[Tr. 60, 61]

The arrangement between petitioner and Signal was mutually profitable and advantageous. Petitioner with its inadequate supply of gas for its Signal Hill plant was either operating unprofitably or had about reached that point. Under the contract with Signal, petitioner received approximately $90,000 a year from the casinghead gas contracts, and Signal retained approximately $75,000 a year with very little expense [Tr. 60, 61] other than the amortization of the $85,000 it paid for its approximate 30% interest in the casinghead gas contracts. [Tr. 239, 62, item 20.]

In Schedule D of its income tax return for 1952 the petitioner reported a long term capital gain of $94,440.84 from the sale of capital assets. In an accompanying schedule in explanation of the gain the petitioner showed the sale of four automobiles, two parcels of real estate and some casing as having been made on August 31, 1952, and prior thereto during 1952. In further explanation the petitioner showed as having been sold on November 1, 1952, the following: "Signal Hill Absorption plant, State Lease PRC 421, and Bishop Tank farm." The gross sale price of the foregoing was shown in a single amount as $135,000. Also shown in single amounts were depreciation, $973,441.76; cost $1,013,664.67, and gain, $94,777.09. [Ex. 6, Tr. 189-202.]

After making a field investigation of the petitioner's income tax liability for 1952, the respondent determined that $85,000 of the $94,777.09 reported by petitioner as long term capital gain from the sale of the absorption plant, the state lease gas contracts and the tank farm constituted ordinary income, giving the following explanation in the notice of deficiency for his action:

> "You reported as long term capital gain the sum of $85,000 received during the taxable year from Signal

> Oil and Gas Company under the terms of an agreement dated November 1, 1952, providing for the processing by that corporation of wet gas from certain properties located in the Signal Oil Field District which were covered by your previous agreements with the producers." [Tr. 269.]
>
> "It is held that the sum of $85,000.00 received in the taxable year constitutes ordinary taxable income under the provisions of section 22 of the Internal Revenue Code of 1939 instead of long term capital gain as reported on your return." [Tr. 13, 14, 15.]

Under the processing arrangement with Signal respecting the eight producers' contracts there accrued to the petitioner during the months of November and December, 1952, total income in the amount of $11,351.41. [Tr. 61.] In its income tax return for 1952, the petitioner reported that income as ordinary income. Like income accruing to the petitioner in subsequent years has been so reported by it in its returns for those years. [Tr. 270.]

Errors Relied Upon.

1. The Tax Court erred in failing to find that petitioner as an operator of a casinghead gas plant was a manufacturer and not a mere renderer of services for compensation and that it used the eight casinghead gas contracts in its business and that such contracts constituted valuable assets.

2. The Tax Court erred in failing to find that petitioner sold to Signal its eight casinghead gas contracts, or alternatively, approximately a 30% interest in said contracts and reserved the remaining 70% interest.

3. The Tax Court erred in failing to find that Signal was also a manufacturer with respect to its interest in said

contracts and with respect to said interest was manufacturing for itself and not working for petitioner.

4. The Tax Court erred in failing to find that the $85,000 and $11,351.41 received by petitioner from Signal were items of income subject to treatment as long term capital gain.

5. The Tax Court erred in deciding that there was a deficiency in petitioner's 1952 Federal corporate income tax liability of $14,343.52.

6. The Tax Court erred in failing to find that petitioner has overpaid its 1952 taxes by $10,688.30.

Summary of the Argument.

Though petitioner was not an extractor of wet gas from its deposit under the ground for depletion purposes, it was more than a renderer of services for compensation. It was a manufacturer acquiring title to the wet gas, changing its form in its plant by the use of capital, labor and management, and selling its finished products.

Petitioner had owned for more than six months eight casinghead gas contracts which entitled it to the exclusive output of wet gas of certain oil wells. These contracts were used by petitioner in its trade or business and were not held primarily for sale.

Said casinghead gas contracts constituted property and valuable property, although they were more valuable in the hands of casinghead gas processors who had a greater supply than did petitioner.

Petitioner sold to Signal said contracts for $85,000 and further amounts measured by production.

Alternatively, petitioner sold to Signal approximately a 30% interest in said contracts for $85,000 and the obligation of Signal to process petitioner's reserved 70% interest in said contracts. The parties to the contract in their books and tax returns so treated the matter. Petitioner reported the $85,000 received for the 30% interest in the contracts as long term capital gain and treated the rest of the money it received from Signal as ordinary income received in its gas processing business.

Signal reported the $85,000 on its books and income tax returns as the cost of a 30% interest in the contracts and amortized said cost over their probable life. The 70% interest of the proceeds which it paid to petitioner was treated by Signal as deductible royalty.

Sales of part interests in contracts are quite customary in businesses carried on in the oil, real estate and patent field.

The fact that there were some restrictions on Signal's rights to dispose of the casinghead gas contracts does not preclude the transaction from being a sale of an interest in the contracts. Signal could have assigned the contracts to anyone who would take them subject to the same conditions under which it held them. Signal or its assignee could have used the contracts as long as they desired.

Petitioner sold a 100% or alternatively a 30% interest in the casinghead gas contracts and is entitled to long term capital gain on the proceeds, either under Sections 117(c)(2) and 117(a), or 117(j).

ARGUMENT.

I.

Petitioner, as an Operator of a Casinghead Gas Plant Was a Manufacturer and Not a Mere Renderer of Services for Compensation.

It is clear from the opinion of the Tax Court, pages 39 and 40 of the Transcript, that the Tax Court thought that petitioner was merely performing services for the wet gas producers and eventually that Signal merely performed part of those services. The Tax Court apparently arrived at this conclusion from a reading of *Helvering v. Bankline Oil Company,* 303 U. S. 362, which held that Bankline did not have an economic interest in the wet gas in the earth which entitled it to depletion deductions. The Tax Court obviously failed to recognize that for the purpose of determining the right to take depletion deductions a distinction is properly made between producers of wet gas and processors of wet gas. A processor does not have an economic interest in the oil and gas in place, but he might still be classed as a manufacturer.

In a broad sense, everyone renders a service, even General Motors Corporation. However, in a narrower sense, General Motors Corporation is a manufacturer; it is buying raw materials, processing them in its plants using labor management and capital and selling the finished product.

Likewise, Bankline was a manufacturer, using its own plant, buying raw materials and through the use of labor, capital and management changed the nature of the raw materials, producing a finished product which it owned and sold. [Tr. 183.] While it rendered a service to the world, it rendered it as a manufacturer, not as a mere renderer of services for hire.

Bankline, under the eight casinghead gas contracts, obtained title to the wet gas because the wet gas from all of the producers was commingled [commingling authorized, Tr. 74 and 76] and the form of the product was changed [from wet gas to gasoline, Tr. 72] so that it was no longer identifiable, and as the "purchase price" [Tr. 71] for the delivery of the raw materials, Bankline agreed either to return a different product or money. [Tr. 72.] Under these circumstances, there was a sale of the wet gas to Bankline and not a bailment for hire. Accordingly, Bankline was a manufacturer and not merely a performer of services.

In *Alamitos Land Company v. Texas Company,* 11 Cal. App. 2d 614, the Court held that a casinghead gas contract was a contract of sale because the wet gas was delivered to the casinghead gas operator who obtained title and thereby became the owner and not a bailee, for the reason that there was a commingling of the gas from the various producers and the substances of the wet gas was changed so that it completely lost its identity. The court spoke of the gasoline "manufactured" from the wet gas. In the *Alamitos* case, the following language was quoted from the case of *Scott Mining and Smelting Company v. Shultz,* 67 Kan. 605, 73 Pac. 903:

> "If the identical thing delivered is to be returned, it is a bailment, and there is no transfer of title; but if the one to whom it is delivered may return another thing of the same kind, or an equivalent in the form of money, or otherwise, it will ordinarily constitute a sale and effect a change of title."

Courts in other states have held that title to wet gas passes to the casinghead gas processer under casinghead gas contracts. *Saulsbury Oil Company v. Phillips Petroleum Company* (C. A. 10), 142 F. 2d 27, cert. den.,

323 U. S. 727; *Martin v. Amis* (Tex. Com. App.), 288 S. W. 431. It is clear from these authorities that Bankline was not merely performing work or services for the gas producers but it was a manufacturer buying raw materials, changing their form and nature, destroying their identity in its plant through the use of capital, labor and management, receiving title to the casinghead gas and owning and selling the finished products.

By the same token, Signal, as a casinghead gas operator, was also a manufacturer and not merely a renderer of services for hire.

II.

The Casinghead Gas Contracts Were Assets Used by Petitioner in Its Trade or Business, Were Not Held Primarily for Sale and Had Been Held for More Than Six Months and Were of Great Value.

As a manufacturer, Bankline had a plant, labor and capital and it had contracts which entitled it to receive raw materials. These contracts, like patents, or leases and other intangible assets, were assets used by it in its trade or business. Petitioner held these contracts for more than six months and was not in the business of buying or selling casinghead gas contracts. The casinghead gas contracts were definitely property and valuable property. Article 223 of Regulation 45 (not now in effect) recognized that casinghead gas contracts were property. The regulation read:

> "Casinghead gas contracts have been construed to be tangible assets * * *."

In *Boynton Gasoline Company*, 6 B. T. A. 434, and 10 B. T. A. 19, the casinghead gas contracts there involved were held to be depreciable property and includa-

ble in "invested capital" at a value, for excess profits tax purposes, of $100,000.

Contracts of other kinds have been held to be property and capital assets. In *Commissioner v. Goff* (C. A. 3), 212 F. 2d 875, cert. den., 348 U. S. 890, it was a contract entitling the holder to buy all of the hosiery produced by specific machines in a certain plant; in *Commissioner v. McCue Brothers and Drummond, Inc.* (C. A. 2), 210 F. 2d 752, it was a lease of realty; in *Jones v. Corbyn* (C. A. 10), 186 F. 2d 450, it was an insurance agency contract; in *United States v. Jones* (C. A. 10), 194 F. 2d 783, and in *Vermont Transit, Inc. v. Commissioner* (C. A. 2), 218 F. 2d 468, there were bus franchises.

The casinghead gas contracts in the case at bar were valuable property especially when owned by a casinghead gas operator who had an economic amount of wet gas to process. This is clearly evident from the record in this case, especially pages 60 and 61 of the Transcript.

The casinghead gas contracts owned by petitioner were therefore either capital assets held for more than six months or were depreciable property held for more than six months and used by the taxpayer in connection with its trade or business. Under Section 117(a) or 117(j) of the Internal Revenue Code of 1939, the profit on this sale would be long-term capital gain or treated as long-term capital gain. Section 117(c)(2).

III.

Petitioner Sold to Signal an Interest in the Casinghead Gas Contracts.

The resolution of petitioner's Board of Directors authorized it to sell its entire interest in the casinghead gas contracts, and it gave a bill of sale for the entire interest in said contracts and the contract with Signal provided that the contracts were to be sold to Signal. Petitioner accordingly took the position before the Tax Court that such entire interest was sold and if such position is here upheld, it would necessarily follow that petitioner is entitled to capital gains treatment not only as to the $85,000 but also as to the $11,351.41.

It so happens, however, that the parties have treated the transaction on their books and tax returns as a sale of approximately a 30% interest and the reservation by petitioner of the balance of the rights under the casinghead gas contracts.

It is now submitted that even if petitioner is bound by the foregoing developments (and the Tax Court's findings thereon) still petitioner, even though not entitled to the capital gains treatment on the above $11,351.41, would nevertheless be entitled to such treatment on the foregoing $85 000 since, as shown below, there was at least a sale of a 30% interest by petitioner and the $85,000 gain was entirely attributable to the sale of such 30% interest which constituted a capital asset under the authorities herein discussed.

On the basis of the then price of 8.33¢ per gallon, Signal was entitled to 2½¢ per gallon, which is 30% of the above 8.33¢ and likewise if this last mentioned figure increased or decreased such 2½% increased or decreased

proportionately. [Tr. 183.] It therefore follows that, in substance and effect, Signal's purchase was always equal to a 30% interest and the remaining 70% interest was reserved by petitioner.

Petitioner reported the $85,000 as the sale proceeds of the contracts and as long-term capital gain and treated the additional receipts from Signal, which came out of production, as being ordinary income.

Signal on its books and tax returns capitalized $85,000 as the cost of an interest in the casinghead gas contracts and amortized this over their probable life. Signal has deducted as royalties the remaining 70% of the proceeds from the sale of the products and has not treated these amounts as being part of the purchase price of the contracts. (*Supra,* p. 13.)

It is to be noted that Exhibit 5, Transcript, page 188, the indemnity agreement on the income tax treatment, related to the $85,000 only, the amount petitioner received for the 30% interest in the contracts.

This treatment or interpretation by the parties is entitled to weight and is consonant with the Tax Court's finding that petitioner continued to maintain gas gathering lines, meter the gas and pay royalties to the gas producers and had expenses in connection with said operations and received ordinary income offsetting such expenses, with the balance constituting net ordinary income.

Petitioner, however, sold to Signal an interest in the casinghead gas contracts and Signal became the owner of such interest and thereafter acted as a manufacturer for its own account as to that part. That part constituted 30% of the natural gasoline and propane to be produced. [Tr. 182-183.]

Signal, as the purchase price of its 30% share, paid $85,000 and, of course, agreed to process its own wet gas and process petitioner's royalty share of the wet gas as well as the royalty share going to the wet gas producers.

In other words, petitioner sold the contracts for $85,000, but reserved from the sale approximately 70% of the production. [Tr. 182-183.]

An asset may be sold in its entirety or in part. This is well illustrated in the patent field where the law on contract rights is well developed.

For example, in *United States v. Carruthers* (C. A. 9), 219 F. 2d 21, the inventor had a process and sold rights under the patent for use only in the tuna industry. He kept the rights for use in other industries. Nevertheless the transaction was held to be a sale.

In *Vincent A. Marco,* 25 T. C. 544 (dismd. C. A. 9, 1956), the inventor was given capital gain treatment on the sale of an interest in a patent to be used only west of the Mississippi River.

In *Cavanaugh v. Evans* (C. A. 6), 188 F. 2d 234, the inventor was given capital gain treatment on the transfer of an interest in a patent although he retained the use of the invention for himself and one assignee.

In *First National Bank of Princeton v. United States,* 136 Fed. Supp. 818, a patent covered the manufacture of brushes and the inventor sold the right to make, use and sell tooth brushes only and retained the right to use the patent for other kinds of brushes. Nevertheless, he was given capital gain treatment.

In *Merck & Company, Inc. v. Smith,* 155 Fed. Supp. 843 (affd. C. A. 3, 11-24-58), the taxpayer had a patent

on sulfa drugs and it sold the right only on sulfadiazine. Nevertheless, it was given capital gain treatment.

These cases indicate that it is not unusual to sell merely part interest in certain rights and that is what petitioner did. It sold to Signal for the full economic life of the wet gas resources, the right to 30% of the gasoline and propane. The amount received for such rights was, as indicated above, $85,000, plus the liability of Signal to process the balance of the wet gas.

The Tax Court stated, as one of its grounds for holding that the entire effect of the transaction between petitioner and Signal was a contract for services and not a sale, that if Signal did not desire to receive or process the wet gas produced from the properties covered by the producer's contracts, Signal would not be free to dispose of the contracts immediately in any way it saw fit. [Tr. 41.] It must give petitioner notice of its desire not to receive or process any further gas and petitioner upon payment to Signal of the sum of $10 would be entitled to have the contracts reassigned to it. The Court said that Signal's profits or gains from the contracts were limited solely to the amounts received under the arrangement of November 1, 1952, with respect to the natural gasoline and propane gas which was sold after it processed the casinghead gas. [Tr. 41.]

It may be reasonably inferred from the assignment contract that the parties expected that the wet gas would be completely depleted within ten years; hence, Signal had the right to take the wet gas under these eight contracts for their probable productive life. Furthermore, Signal had the option after 10 years to keep the contracts or to sell them back to petitioner.

These restrictions should not preclude this transaction from being a sale.

In the patent field many courts have held that some restriction on the sale of the patent by the assignee did not preclude the transaction from being a sale by the assignor to the assignee.

In *Edward C. Myers,* 6 T. C. 258, the possibility of reverter was considered as a condition subsequent and did not preclude a sale. That case has now been acquiesced in by the Government. Rev. Rul. 58-353, I. R. B. 58-29. To the same effect, see *Pike v. United States,* 101 Fed. Supp. 100. In *Allen v. Werner* (C. A. 5), 190 F. 2d 840, the court found the fact that the agreement was terminable at the vendee's option on notice or at the vendor's option for breach did not preclude a sale. That same case held the fact that the assignee was prohibited from assigning except on the transfer of all of its assets, business and good will did not preclude a sale.

In *Carroll Pressure Roller Corporation,* 28 T. C. 1288, Acquiescence I. R. B. 1958-46, the transaction was held to be a sale of a patent although the licensor retained royalties, retained foreign rights, retained the right to veto an assignment and the right to terminate the contract on breach thereof.

The Tax Court in the case at bar also seemed impressed by the fact that petitioner accounted for everything but the $85,000 as being part of its own operations. In other words, it treated as its sales, Signal's disposition of the products resulting from the processing of the casinghead gas and treated the amounts retained by Signal as Signal's charges for processing gas. [Tr. 41, 42.]

A somewhat comparable situation involving a patent was held not to preclude a sale. In *General Spring Corporation,* 12 T. C. M. 847 (1953 Memo Tax Court Decision), after the so-called sale of the patent, the assignor continued to deduct depreciation on the patent in its tax returns. Its tax returns showed its business to be that of "licensing patents" and its officers spent approximately ten years endeavoring to develop a market for the assignee's products. The court treated the rendering of services as being part of the cost of making the sale. That situation is somewhat similar to the rendering of services continued by petitioner after its sale of an interest in the contracts to Signal.

The Tax Court, as indicated above [Tr. 41], thought that Signal could not assign the rights under its contract with petitioner until after petitioner had refused to buy the contracts back. The broad principle is that assignability is the rule, non-assignability the exception. See Cal. Civ. Code, Sec. 1044; *LaRue v. Groezinger,* 84 Cal. 281, 283, 24 Pac. 42, where a contract to sell all the grapes grown in a vineyard for ten years was held to be assignable by the grower; *Chandler v. Hart,* 161 Cal. 405, 415, 119 Pac. 516, where an oil lease was held to be assignable by the lessee; 5 Cal. Jur. 2d 283, 39 A. L. R. 1197; *Imperial Refining Co. v. Kanotex Refining,* 29 F. 2d 193, 199, where a contract to purchase all of the oil a lessee would produce from the lease was held to be assignable. Signal could have sold its rights under its arrangement with petitioner to any other casinghead gas contractor who would agree to operate them up to the ten years and offer the contracts back to Bankline when the assignee no longer desired to process the gas. Consequently, Signal could have sold the contract rights at

any time. Its assignee would have the full right to process the wet gas produced under the eight contracts as long as it was possible; namely, for the economic life of such contracts. Such little restriction as there was on the assignability was a condition subsequent and was not onerous and was at the option of Signal or its assignee. As seen above similar restrictions were held not to preclude sales of patents.

Conclusion.

1. Petitioner held the eight casinghead gas contracts for more than six months for use in its trade or business and not primarily for sale to customers.

2. Petitioner's business was that of manufacturing gasoline, propane and dry gas in its plant with the use of capital and labor and it was not a mere renderer of services for hire.

3. Petitioner sold its entire interest in the casinghead gas contracts and is entitled to capital gain treatment on the $85,000 and the $11,351.41 received therefor.

4. Alternatively, petitioner sold approximately a 30% interest in the contracts to Signal for $85,000 and the obligation of Signal to process the balance of the wet gas.

5. Signal was a manufacturer also and as to its interest was not a mere renderer of services for hire, but was manufacturing on its own account.

6. Petitioner is entitled to capital gain treatment on the $85,000 received on the sale of a partial interest in the contracts.

7. The decision of the Tax Court holding that the $85,000 and $11,351.41 constituted ordinary income and not capital gain to petitioner should be reversed.

Respectfully submitted,

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APPENDIX.

Statutes Involved.

Provisions of the Internal Revenue Code of 1939.

Section 117. Capital Gains and Losses.

(a) Definitions.—As used in this chapter—

(1) Capital assets.—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(A) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(B) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 23(1), or real property used in his trade or business; * * *

(j) Gains and Losses from Involuntary Conversions and From the Sale or Exchange of Certain Property Used in the Trade or Business.—

(1) Definition of property used in the trade or business. For the purposes of this subsection, the term 'property used in the trade or business' means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (1), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on

hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or (C) a copy right, a literary, musical, or artistic composition, or similar property, held by a taxpayer described in subsection (a) (1) (C). Such term also includes timber or coal with respect to which subsection (k) (1) or (2) is applicable and unharvested crops to which paragraph (3) is applicable. Such term also includes livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes, and held by him for 12 months or more from the date of acquisition. Such term does not include poultry.

(2) General rule.—If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat, or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. For the purposes of this paragraph:

(A) In determining under this paragraph whether gains exceed losses, the gains described

therein shall be included only if and to the extent taken into account in computing gross income and the losses described therein shall be included only if and to the extent taken into account in computing net income, except that subsection (d) shall not apply.

(B) Losses upon the destruction, in whole or in part, theft or seizure, or requisition or condemnation of property used in the trade or business or capital assets held for more than 6 months shall be considered losses from a compulsory or involuntary conversion.

(c) Alternative Taxes.—

(2) Other taxpayers.—If for any taxable year the net long-term gain of any taxpayer (other than a corporation) exceeds the net short-term capital loss, there shall be levied, collected, and paid, in lieu of the tax imposed by sections 11 or 12 (or, in the case of certain tax-exempt trusts, in lieu of the tax imposed by section 421), a tax determined as follows, if and only if such tax is less than the tax imposed by such sections:

(A) A partial tax shall first be computed upon the net income reduced by an amount equal to 50 percentum of such excess, at the rates and in the manner as if this sub-section had not been enacted.

(B) There shall then be ascertained an amount equal to 25 percentum of the excess of the net long term capital gain over the net short-term capital loss. In the case of any taxable year beginning after October 31, 1951, and before November 1, 1953, there shall be ascertained, in lieu of the amount computed under the preceding sentence, an

amount equal to 26 percentum of the excess of the net long-term capital gain over the net short-term capital loss.

(C) The total tax shall be the partial tax computed under subparagraph (A) plus the amount computed under subparagraph (B).

California Civil Code, Sec. 1044.

All kinds of property.—Property of any kind may be transferred, except as otherwise provided by this article.

Reference to Exhibits

Plaintiff's Exhibit No.	Nature of Exhibit	Page Number Where Identified	Offered	Received	Rejected
11	Contract between Signal Oil and Gas Co. and Southwest Exploration Company	237	238	238	....
12	Contract between Lomita Signal Wilmington Associates and Board of Harbor Commissioners	237	239	239	....
13	Letter dated September 30, 1957	249	250	250	....
14	Revenue Agent's Report dated January 13, 1955	....	259	259	....
15	Journal Entries	276	276	....	276

NOTE: Exhibits 1 to 10 inclusive were included in the Stipulation of Facts which was offered and received in evidence as shown on page 219 of the Transcript. Those exhibits are set out in the Transcript beginning on page 63 and running to page 217 as shown by the Index of the Transcript of Record.